Case for active management is actually strong

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The poor performance of active managers for the past few years has convinced many investors that active management is less worthy.

But this poor performance has its roots in extreme market conditions. Indeed, in times of systemic crises, risk assets tend to recorrelate, reducing diversification and potential alpha opportunities. However, diversification still works in the long run, despite rising correlations during extreme financial events.

The question of whether investment managers generate superior risk-adjusted returns (“alpha”) is widely discussed among financial economists. This debate has become highly technical in recent years, largely linked to statistical measurement problems. For example, a multi-factor model is usually used to estimate the risk-adjusted return of managers. However, some recent studies show these estimates are biased, since these factor models produce significant negative alphas even for passive benchmark indices such as the Russell 2000. Moreover, alpha estimates implicitly suppose that managers have constant factor expositions, while about one-third of managers change the dominant investment style of their funds.

Additionally, research indicates that the further a manager deviates from a given benchmark, the greater the potential for relative gains.

A study conducted by two finance professors at Yale School of Management found what they describe as active share – the proportion of an active fund that differs from the portfolio’s benchmark index – to be a key determinant of long-term above-market returns.

The most difficult task is nevertheless to distinguish skill from pure luck. A common approach to this problem is to test for persistence in fund returns, that is, whether past winners continue to produce high returns. Unfortunately, academic studies at this stage do not allow us to draw a definitive conclusion.

In one of the most recent studies published in the Journal of Finance, Laurent Barras, Olivier Scaillet, and Russ Wermers use a new statistical approach to evaluate the talent of active managers. They show that the majority of actively managed domestic equity mutual funds have generated at least a zero alpha, after adjusting for luck, trading costs and fees. They also indicate there is a small group of funds that exhibit true positive high outperformance, even if their proportion has been shrinking over time. Their second most encouraging conclusion is that if investors can avoid what is shown to be a relatively small fraction of truly unskilled funds, they can expect to do at least as well with actively managed funds as with passively managed/index funds.

Passive management risks are probably different in nature, but the risk is still there. Almost all major indexes are based on market-capitalisation weightings. A passive index investor is thus forced to allocate more of her portfolio to overvalued stocks and less to undervalued stocks. A number of studies point out that this mechanism of capitalisation weighting creates a kind of trend following a strategy profile whose risk/return trade-offs are inefficient. Who is going to lead the market and where then?

More important, pure passive portfolios are managed without placing valuation judgments on the macroeconomic and/or market conditions. In pure passive portfolio approach, risk budgets and risk positions are not managed. Moreover, the composition of indices is somewhat arbitrary since it depends on the proposition of an index provider with sufficient market power. Finally, passive portfolios are subject to a risk of liquidity. Delisting companies and bankruptcies could have a strong negative impact on the index performances.

Leaving our money in the (invisible) hands of benchmark constructors is not a safer choice than to delegate its management to one or several carefully selected, talented portfolio managers with a clear process.

In such a process, quantitative and qualitative analyses should be complementary.

Indeed, recent research by the Cass Business School’s Pensions Institute (see FTfm March 29) concludes investors should pay close attention to fund flows (and to resulting fund size), as well as to career paths of fund managers. Past performance is only an indicator of future performance if the manager is not replaced, of course, and if second fund flows do not eliminate the persistence.

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